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MONETARY POLICY REPORT FOR 1988

FROM THE

COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS UNITED STATES SENATE

ONE HUNDREDTH CONGRESS

SECOND SESSION

A REPORT

together with

ADDITIONAL VIEWS

SUBMITTED PURSUANT TO PUBLIC LAW 95–523

AUGUST 25, 1988.—Ordered to be printed
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LETTER OF TRANSMITTAL

U.S. SENATE,
COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS,
Washington, DC, August 25, 1988.

Hon. GEORGE BUSH,
President of the U.S. Senate,
Washington, DC.

DEAR MR. PRESIDENT: Transmitted herewith is the Monetary Policy Report for 1988 on the conduct of Monetary Policy, pursuant to Public Law 95–523 and oversight hearings held on February 23 and 24, 1988, and July 12 and 13, 1988.

Sincerely yours,

WILLIAM PROXMIRE, *Chairman.*

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AUGUST 25, 1988.—Ordered to be printed

Filed, under authority of the order of the Senate of August 11 (legislative day, August 10), 1988

Mr. PROXMIRE, from the Committee on Banking, Housing, and Urban Affairs, submitted the following

REPORT

together with

ADDITIONAL VIEWS

[Submitted pursuant to Public Law 95-523]

INTRODUCTION

On February 23, 1988, the Committee on Banking, Housing, and Urban Affairs commenced its 1988 monetary policy hearings, called for in the Balanced Growth Act of 1978. On that day, the Committee received the Federal Reserve's "Monetary Policy Report to Congress" and heard the testimony of its chairman, Alan Greenspan, on the conduct of monetary policy during the second half of 1987 and the Federal Reserve's monetary policy objectives for 1988.

At the second hearing, four nationally recognized policy experts with diverse perspectives expressed their views on the conduct of monetary policy for the Committee's consideration and discussion. The witnesses were: Robert J. Barbera, Chief Economist, Shearson Lehman Hutton, New York; Richard Cooper, Harvard University; Jeffery Sachs, Harvard University; and Neal Soss, Chief Economist, the First Boston Corporation, New York.

On July 12, 1988, the Committee on Banking, Housing, and Urban Affairs commenced its second set of monetary policy hearings for 1988, called for in the Balanced Growth Act of 1978. On that day, the Committee heard from four distinguished experts on the conduct of monetary policy and its relationship to politics and economic performance. The witnesses were: Alan Blinder, Professor

of Economics at Princeton University; Rudiger Dornbusch, Professor of Economics at Massachusetts Institute of Technology; Ray Fair, Professor of Economics at Yale University; and David Hale, Chief Economist and First Vice President at Kemper Financial Services.

On July 13, 1988 the Committee received the Federal Reserve's "Monetary Policy Report to Congress" and heard the testimony of its chairman, Alan Greenspan, on the conduct of monetary policy during the first half of 1988 and the Federal Reserve's monetary policy objectives for late 1988 and 1989.

The two sets of testimony from the Federal Reserve's chairman and the two panels of private sector and academic experts offered the Committee ample information on which to base the Committee's findings and recommendations. The Committee's findings and recommendations again address the implications of international economic interdependence. The Committee also finds that the political pressure on the Federal Reserve has been unusually high in the aftermath of the stock market crash.

The Committee's findings and recommendations are herewith transmitted to the Senate for its consideration and use.

The Performance of the Federal Reserve in 1987

The growth of the monetary aggregates in 1987 was somewhat below the lower end of the target range for M2 and at the lower bound of the target range for M3. [See table 1] The growth of debt was at the midpoint of the target range for the year.

The slower than expected monetary growth appeared to reflect the Federal Reserve's response to stronger than expected economic growth and a fear of a revival of inflation resulting from the domestic effects of the depreciation of the dollar and the revival of oil prices early in 1987. In addition, money growth was retarded somewhat by the joint decision of the Federal Reserve and the Administration to enter into an international agreement in late February to stabilize the exchange value of the dollar. This placed additional responsibility upon the shoulders of the Federal Reserve. The necessity of defending the reference range for the dollar vis-a-vis foreign currencies, that was established in the so-called Louvre Accord, required to the Federal Reserve to slow the rate of m oney growth when the dollar came under downward pressure. This influence on monetary policy appeared most prominently in April and again in September–October of 1987.

In the period after the stock market crash in October, the focus of monetary policy appeared to shift toward somewhat faster reserve growth with the emphasis upon the provision of adequate liquidity to the financial markets.

TABLE 1.—RANGES OF GROWTH FOR THE MONETARY AND DEBT AGGREGATES

[Percent change, fourth quarter to fourth quarter]

	1987	
	Projected	Realized
M2	5½ to 8½	4
M3	5½ to 8½	5½
Debt	8 to 11	9½

THE PERFORMANCE OF THE FEDERAL RESERVE IN THE FIRST HALF OF 1988

The growth of the monetary aggregates over the first half of 1988 was toward the upper end of, but within, the target ranges specified at the February hearings to apply to 1988. [Table 1b] The growth of debt was also within the range specified in February.

The growth of the monetary aggregates began briskly amid signs that the economy was weakening in January and February. More recently the growth of the monetary aggregates has decelerated somewhat as the economy has strengthened, largely because of the rapid growth of exports. Moves to tighten the availability of reserves between late March and June in response to the fears of the potential for renewed inflation make it likely that the growth of the monetary aggregates will not exceed the upper end of the target ranges during the remainder of the year.

TABLE 1b.—RANGES OF GROWTH FOR THE MONETARY AND DEBT AGGREGATES

[Percent change, at annual rate through June of 1988]

	1988	
	Projected	Realized
M2	4 to 8	7.1
M3	4 to 8	7.0
Debt	7 to 11	8.5

THE FEDERAL RESERVE'S ECONOMIC FORECASTS FOR 1988

Table 2a lists the Federal Reserve's projections of the central tendencies of several key economic variables for 1988 compared to the forecasts made by some other concerns as of mid-February.

TABLE 2a.—FORECASTS AS OF FEBRUARY 1988

	FRB	Administration	CBO	Blue chip consensus
Nominal GNP	5.25 to 6.0	6.4	5.8	5.6
Real GNP	2 to 2.5	2.4	2.3	2.2
GNP deflator	3.25 to 3.75	3.9	3.4	3.4
Civilian unemployment	5.75 to 6.0	5.8	6.2	6.1

One can see from this table that, as of February, the Federal Reserve's forecast was not at all extreme when compared to the projections of the other forecasters. Since the time of the hearing in February, many of the forecasts for U.S. real GNP growth have improved, the forecasts for unemployment have declined somewhat, and projected inflation, as measured by the expected rate of change of the GNP deflator, has increased slightly.

The revisions in these forecasts appear to derive from two sources. First, the risk of a substantial decline in consumer demand in the aftermath of the stock market crash has not materialized to the extent that was feared in February. Second, the stimulus of exports and import-competing industries resulting from the decline in the dollar since 1985 has provided more buoyancy to the economy than appears to have been anticipated when the forecasts were made.

The economic forecasts of the Federal Reserve and others as of mid-July are shown in Tables 2b and 2c. For 1988 the Federal Reserve's central tendency for inflation is slightly higher than that of the other forecasters shown. Their forecast for real GNP growth is somewhat lower than the others. As mentioned above, the forecasts all exhibit an upward revision in expectations of the pace of economic activity when compared with the February forecasts shown in Table 2a.

TABLE 2b.—FORECASTS FOR 1988 AS OF JULY 1988

	FRB	Administration	CBO	Blue chip consensus
Nominal GNP	5.75 to 6.75	6.6	6.7	6.4
Real GNP	2.75 to 3	3.0	3.6	3.4
GNP Deflator	3 to 3.75	3.5	3.0	2.9
Civilian Unemployment	5.25 to 5.75	5.5	5.6	5.5

For 1989, the central tendency of the Federal Reserve's forecast shows somewhat slower real GNP growth and slightly higher inflation than they expect for 1988. The other forecasters estimates are again generally within the same range as those presented in the Federal Reserve's Monetary Policy Report.

TABLE 2c.—FORECASTS FOR 1989 AS OF JULY 1988

	FRB	Administration	CBO	Blue chip consensus
Nominal GNP	5 to 7	7.1	6.7	6.5
Real GNP	2 to 2.5	3.3	2.3	2.2
GNP Deflator	3 to 4.5	3.7	4.3	4.3
Civilian Unemployment	5.5 to 6.0	5.3	5.6	5.5

THE FEDERAL RESERVE'S MONETARY TARGETS FOR 1988 AND 1989

PERCENT CHANGE, FOURTH QUARTER OVER FOURTH QUARTER

	1989	1988	1987
M2	3 to 7	4 to 8	5.5 to 8.5.
M3	3.5 to 7.5	4 to 8	5.5 to 8.5.
Debt	6.5 to 10.5	7 to 11	8 to 11.

The Federal Reserve's 1988 target ranges for the monetary aggregates M2, M3 and Debt were wider by one percentage point relative to the targets for 1987. The midpoint of the range for the targets for M2 and M3 for 1988 are one percentage point below the midpoint of the target ranges from the previous year. The Federal Reserve again chose not to include a target range for M1 in 1988.

The provisional targets for 1989 once again show a lowering of the midpoints of the ranges. M2's midpoint is lowered by one percentage point relative to 1988, M3's midpoint is lowered by one half of one percentage point, and the midpoint of the range for Debt is lowered by one half of one percentage point. In July the Federal Reserve chose not to include a target range for M1 in 1989.

Summary of Testimony—February

On the 24th of February Chairman Greenspan testified before the Committee on the activities of the Federal Reserve in the past year and he presented the Federal Reserve's outlook for 1988.

In discussing the short-term monetary outlook, Chairman Greenspan emphasized the complexity of setting policy in the period after the stock market crash. Conflicting signals, some showing signs impending weakness in the economy, and others suggesting continued strength, made the appropriate course for policy unclear. On balance, Chairman Greenspan testified, the Board of Governors of the Federal Reserve felt that as of mid-January the risk of recession slightly outweighed the risk of renewed inflation. He confirmed that, in late January, the Federal Reserve had decided, in the context of a more stable exchange rate, to "take a further small easing step * * *"

Chairman Greenspan reviewed Federal Reserve performance in 1987 emphasizing that the slower than expected money growth during the first three quarters of the year resulted from attempts to resist a revival of inflation that was brought on by the fall of the dollar, a rise in energy prices, and expanded demand for U.S. exports. After October 19th, according to Mr. Greenspan, money growth increased substantially for a temporary period when the focus was on provision of adequate liquidity to financial markets in the wake of the stock market crash.

Chairman Greenspan testified that the increased variability in the relationship between money and aggregate income made it advisable for the Federal Reserve to widen the target ranges reported to the Committee. He emphasized that the results of interest rate deregulation and financial innovation in recent years have contributed to the greater variability of the money-income relationship.

In response to a question from Chairman Proxmire, Chairman Greenspan suggested that the Federal Reserve Board had given consideration to publishing a target for the monetary base in lieu of the M1 target that they had chosen to discontinue. He testified

that the close relationship beween the variability of the reserves component of the monetary base and the variability of M1 made both of them a somewhat undesirable target for monetary policy at the present time. In response to a subsequent question for the record, Chairman Greenspan provided data on the variability of M1 velocity, monetary base velocity, and the components of each from 1960 through 1987. That data revealed that the variability of the monetary base was similar to that of M1 until the 1980's when interest rate deregulation and other financial innovations, including the establishment of interest-bearing NOW accounts, led to a rise in M1 velocity variability that was significantly greater than the rise in the variability of monetary base velocity.

During the question and answer session, Chairman Greenspan responded to questions on several areas of policy including those addressed to the benefits of, and likely consequences of, fiscal deficit reduction, efforts to increase national savings, the dangers of large accumulations of net indebtedness to foreigners, and the effects of recent political pressure on the Fed.

Chairman Greenspan strongly recommended reduction of the federal budget deficit. He testified that real interest rates have been, and are, too high and that deficit reduction would increase national savings and bring the interest rates down to a more sustainable level.

Chairman Greenspan suggested that a reduction of the U.S. fiscal deficit need not lead to a decline in economic activity. To the contrary, he predicted that a reduction of the federal budget deficit would catalyze an increase in economic activity led by a fall in interest rates and the stimulation of investment and other interest-sensitive sectors.

In response to a question on the unsatisfactory private savings rate in the United States, Chairman Greenspan argued that, while the goal of increasing savings is important to pursue, the results to date of policies designed to promote savings have been disappointing.

Many of the Senators on the Committee expressed concern over persistent increase in indebtedness in the United States, and particular concern was raised over the rise in indebtedness to foreigners. Chairman Greenspan shared the concern of the Committee members and emphasized that growing external indebtedness could have some very negative consequences for U.S. policy in the years ahead. He cited Britain's balance of payments difficulties after World War II as an example of the problems a nation could experience as a result of a large accumulation of external indebtedness. Chairman Greenspan testified,

> We needn't go back very far in history to remember the types of problems we can get. Remember Britain had a very serious problem at the end of World War II with very large external sterling liabilities which it gradually unwound. But during the process it was very obvious that those international obligations had a very significant effect on domestic economics and politics of Britain.

Chairman Greenspan was also asked about the substantial political pressure placed on the Federal Reserve by the Administration

in late 1987 and early 1988. Comments by Treasury Secretary Baker, Council of Economic Advisors Chairman Beryl Sprinkel, and a letter sent from Assistant Secretary of the Treasury, Michael Darby to the Federal Reserve Governors and the Presidents of the Reserve District Banks were all evidence of political pressure on the Federal Reserve. It was further noted by Chairman Proxmire that all of the current Federal Reserve governors were appointed by the Reagan Administration. Only President Roosevelt and President Wilson, at the time of the Federal Reserve's creation, have previously appointed the entire board.

Chairman Greenspan testified that he had, "objected quite strongly," to Dr. Darby's letter. He indicated that he had some disagreements with both Dr. Darby and Dr. Sprinkel. In discussing the entire problem of political influence on the Federal Reserve, Chairman Greenspan stated,

> The only thing I hope does not happen is that the concern of our responding to political pressures gets so extraordinary that we will feel a necessity to do precisely the opposite and we could very well be taking actions which would be counter to our best judgment. That is the type of problem which concerns me more than my concern that the current administration will pressure us into doing things that we don't think are appropriate for monetary policy for this country.

On Thursday, February 25, a panel of economists appeared before the Committee to discuss the current economic situation and the appropriate setting of monetary policy. The witnesses were Robert J. Barbera, Chief Economist, Shearson Lehman Hutton, Richard N. Cooper, Professor of Economics, Harvard University, Jeffery Sachs, Professor of Economics, Harvard University, and Neal Soss, Chief Economist, First Boston Corporation.

In his opening statement, Mr. Barbera emphasized that the range of options that were open to the Federal Reserve in 1987 were limited, in large part because of the need to maintain an orderly flow of financing from abroad. He stated that the Federal Reserve was compelled to tighten in the spring and fall of 1987 by signs in the real economy of accelerating inflation and by bouts of dollar weakness. He emphasized that the U.S. is now dependent upon foreign capital to finance economic activity and that to assure that capital inflows will be voluntary the Federal Reserve was required to periodically tighten to assure foreign creditors that U.S. spending could be slowed and that imports would decline. The slowing of import growth would imply, according to Mr. Barbera, less dependence on foreign capital in the future. He also suggested that under plausible assumptions the U.S. net indebtedness to foreigners could reach between ½ and 1 trillion dollars by 1992.

Mr. Barbera also reported that concern about the sustainability of foreign financing of U.S. trade was instrumental in the developments that led to a stock market crash in October of 1987. He claimed that investors watch the trade numbers each month to ascertain if the U.S. economy is adjusting to lessen its dependence on foreign capital.

In reference to the causes of the stock market crash, Mr. Barbera testified that the trade announcement on October 14, 1987 played a prominent role. He asserted,

> As I see it, it was just such a disappointment on October 14, 1987 that burst the bubble of investors looking for receding capital needs and catalyzed the October crash.

On the question of the Fed's responsibility for the crisis, Mr. Barbera states,

> The Fed's second tightening, then played only a small role in the stock market fall. Foreign anxiety about our trade deficit was central.

Mr. Barbera felt that the Federal Reserve's decision to ease after the crash was appropriate. He also felt that in the aftermath of the stock market crash the likely slowdown in the economy would help to improve the trade deficit and give the Federal Reserve somewhat more leeway in the setting of monetary policy. He felt that the slight ease in monetary policy in January, that Chairman Greenspan had revealed in his testimony, was appropriate.

Professor Cooper focused on several important international issues affecting monetary policy in his opening statement. He opposed a further decline of the dollar because he feared that it might create a recession in Europe and Japan. He felt that those economies were fragile at present, given the extent of the adjustment required of them in response to the dollars decline over the previous 2 years. However, Dr. Cooper did not support using tight monetary policy in the United States to stabilize the dollar. At the same time he felt that the United States should not object to other countries intervening in the foreign exchange market to support the dollar, particularly when that intervention facilitates monetary expansion in the other major countries.

Dr. Cooper expressed concern that a recession and higher interest rates would exacerbate the developing country debt crisis. He believed that they would experience great difficulties with another round of austerity.

In reference to the implications for monetary policy of the rapid growth of net indebtedness to foreigners, Dr. Cooper suggested that it was the greater integration of financial markets rather than the debtor or creditor position that was important. He believed that U.S. monetary policy would become more sensitive to the world financial community in the years ahead.

While expressing satisfaction with the current setting of monetary policy, Professor Sachs' opening statement stressed the need to maintain flexibility in the making of monetary policy during the economy's transition from domestic-led growth to export-led growth.

Dr. Sachs emphasized that uncertainty during the period of sectoral transition made it very difficult to predict what is the appropriate level for the exchange value of the dollar. In light of this uncertainty he cautioned against entering into international agreements to pay the exchange rate.

The developing country debt crisis did, in Dr. Sachs view, constitute a constraint on monetary policy. He added that our overall debt strategy was poor and unrealistic. He stated that,

> * * * to hold monetary policy hostage to very poor debt management policy is itself adding a disaster on top of a disaster.

Finally, on the question of political influences on Federal Reserve behavior in an election year, Professor Sachs found little evidence of fine-tuning in the fourth year of the President's term, but found a very strong effect in the first year of a President's term. Dr. Sachs cited the findings of his research which showed that a Republican administration was much more likely than a Democratic administration to begin a presidential term with a recession.

The fourth member of the panel, Dr. Neal Soss, also highlighted the structural transition from domestic-led growth to export-led growth for the U.S. economy in his opening statement. In his statement, Dr. Soss discussed the difficulties of regulating the pace of business expansion in a deregulated financial environment. Dr. Soss stated that,

> * * * there is no clear calibration between the degree of setback suffered in financial markets and the cooling of demands on the economy that is induced.

Dr. Soss found that the instability of the money-income relationship forced the Federal Reserve to place less emphasis on the monetary aggregates in setting policy. Inflation, the pace of business expansion, and the foreign exchange market often provided more reliable signals of activity in his estimation.

The Fed did not show a systematic tendency to create an economic expansion in election years according to Mr. Soss. But he did find that the Fed made an effort to make smaller adjustments in the federal funds rate to, "avoid involvement at politically sensitive times."

Lastly, Dr. Soss discussed the fact that exchange rate management is an area where the Fed's independence is deliberately circumscribed. He emphasized that the dollar is an instrument of foreign policy and is therefore, "within the purview of the Executive."

Dr. Soss predicted that the rest of the world would have to absorb several hundred billion dollars more of U.S. debt in the years to come. He also underscored the costs of raising short-term interest rates to defend a given level of the exchange rate and cited the experience of the April–October of 1987 as evidence of the difficulties that accompany such policy initiatives.

In the question and answer period the panelists entertained questions on the political independence of the Fed, the problems of inflation associated with increases in the rate of capacity utilization, the growth of debt, the likelihood of a recession in 1989, the benefits of deficit reduction, and the possibility for international monetary reform.

The panelists appeared to agree that the existing degree of independence of the Federal Reserve from the political system is working well. None of the panelists supported a move to place the central bank under the authority of the Treasury department.

Dr. Cooper pointed out that in the present U.S. government structure the Federal Reserve is in charge of domestic monetary policy and the Treasury is in charge of exchange rate policy. He felt that such a structure was fine under the fixed exchange rate system of Bretton Woods, but that it was anomalous in the current setting and created tension between the Fed and the Treasury today.

The panelists discussed the current state of employment and capacity utilization in reference to the dangers of inflation. Dr. Barbera offered that most of the high capacity utilization existed in production of goods toward the low end of the valueadded chain, such as paper and chemicals.

Dr. Cooper suggested that the relevant measure when analyzing an industry's capacity utilization is the state of worldwide capacity utilization in that industry. He emphasized that there is worldwide excess capacity in most industries today and that the likely result of high capacity utilization in this country is not a bottleneck and a run up in prices, but greater imports, provided that we not have import controls. He also suggested that to correct the trade balance in the longer term one would need to keep pressure on in the markets to encourage domestic producers to expand capacity and displace imports with domestic production.

On the question of employment and inflation, Dr. Sachs suggested that the so-called NAIRU [Non-Accelerating Inflation Rate of Unemployment] was close to the current level of unemployment and that an inflationary buildup in wages could result if unemployment were to drop by another percentage point. He also expressed the view that the relationship between inflation, unemployment, and wage growth was not likely to have been altered by the presence of increased foreign competition.

The witnesses were asked if they shared the concern of Harvard economist Robert Reich, who emphasized that our accumulated trade deficits will put us in a position that will require dramatic declines in our standard of living if we are to repay the external debt. Dr. Cooper expressed some concern about the U.S. selling assets to service our debt and that the assets would be sold even more cheaply as the dollar continues to fall. He also mentioned that Dr. Reich's comment is somewhat inaccurate in that we do not necessarily need to repay the debt's principal as long as we continue to service the debt.

Dr. Sachs suggested that servicing the debt did constitute some burden but that the debt service to GNP ratio at present was in the neighborhood of 1 percent and that it was surely manageable at the present time.

Dr. Barbera felt that the two bouts of dollar weakness in 1987, both of which occurred after disappointing trade announcements, were a symptom of the hesitance of foreigners to continue to finance our trade deficits. He felt that real adjustment would be forced on the U.S. economy because of the lack of voluntary financing and that the trade balance would close in the next few years as consumer spending is forced to decline.

Dr. Soss offered that the financing process would continue without necessitating repayment of principal. But he also believed that raising new debt would be difficult. He cited the fact that foreign

official purchases were large at Treasury auctions in the last year in support of the notion that private capital would not be forthcoming. He suggested that foreign capital inflows would increasingly be concentrated in the buying up of companies through direct investment in the United States.

The panelists expressed a variety of views in a discussion on the impact of fiscal policy on the world economy in the recent past, and on the prospects for the economy in the event of fiscal deficit reduction in the United States in the near future. Dr. Barbera believed the United States had served as an engine of worldwide growth between 1983 and 1986. He offered that stimulative policies in this country had invigorated foreign economies by expanding our import demand. Dr. Sachs believed that the stimulation of foreign exports was offset by the transmission of high real interest rates worldwide resulting from the U.S. tight money-stimulative fiscal policy mix.

Prospectively, Dr. Sachs estimated that a decline in the federal budget deficit accompanied by a loosening of monetary policy would stimulate investment in this country and abroad. He, like Chairman Greenspan the day before, suggested that on net federal deficit reduction could spur economic growth.

Chairman Proxmire expressed some doubt about the stimulative effects of fiscal contraction and cited William McChesney Martin's statement that one "can't push on a string", meaning that interest rate declines are insufficient to stimulate a stagnant economy. Dr. Cooper supported the Chairman's view and suggested that the proper way to view this problem was by introducing the time dimension. He believed that in the short run fiscal contraction would depress economic activity and discourage investment. Dr. Cooper also offered that some stimulation of economic activity could result from the lessening of the debt service burden of the liquidity-constrained developing countries.

Finally, Dr. Cooper suggested that the industrial countries adopt a single currency to minimize the disruption of the real economy resulting from disturbances in the financial markets. Dr. Cooper illustrated the potential benefits of his proposal by referring to the current reluctance of U.S. firms to expand capacity out of fear that the exchange value of the dollar will rise again soon despite the sizeable trade deficit in this country.

Summary of Testimony—July

In July the Committee heard testimony from a panel of experts on monetary policy on July 12, and from Chairman Greenspan on July 13. The panel consisted of Dr. Alan Blinder, Chairman of the Department of Economics at Princeton University; Dr. Ray Fair, Professor of Economics at Yale University; Dr. Rudiger Dornbusch, Professor of Economics at Massachusetts Institute of Technology; and David Hale, Chief Economist and First Vice President at Kemper Financial Services.

In his opening statement, Dr. Blinder testified that the Federal Reserve Board has done a good job in recent years. He cited the declines in unemployment and the fact that inflation had largely remained in check in support of his view.

For the near future Dr. Blinder suggested that there are two pitfalls for the Federal Reserve to avoid if it is to continue to perform admirably in the making of monetary policy. In Dr. Blinder's view the Federal Reserve should not pay undue attention to the inflation hysteria that emanates from Wall Street and they should refrain from making agreements to support the exchange value of the dollar at unsustainable levels in the future.

Dr. Blinder presented evidence that the composition of real gross national product would have to continue to adjust in the direction that it had been doing since 1986 to restore better sectoral balance to our economy. He showed that after a rise in consumption and government spending and a fall in net exports over the seven years ending in 1986, the economy has experienced a reversal of these trends in 1987 and 1988. Dr. Blinder suggested that we have experienced ½ to ¼ of the needed readjustment to date.

To facilitate the sectoral readjustments Dr. Blinder emphasized that a change in the monetary-fiscal policy mix was needed. He advocated a policy mix which produces a reduction in the federal budget deficit and an easing of monetary policy. He suggested that the appropriate change in the policy mix would produce a reduction in interest rates and a decline in the foreign exchange value of the dollar.

In response to a question in the letter of invitation to the hearing, Dr. Blinder testified on a variety of indicators that could be used to guide in the setting of monetary policy. His written testimony included charts which showed that the correspondence between nominal GNP growth and M1 growth was very weak from the third quarter of 1984 to the end of the first quarter of 1988. He also presented a chart showing that the growth rate of M1 velocity was inversely related to the growth rate of M1. Dr. Blinder suggested that M1 would not be useful as a target for monetary policy and that the Federal Reserve had appeared to offset the erratic behavior of M1 velocity with counteracting shifts in M1 growth and that their actions had stabilized the growth of nominal GNP.

Dr. Blinder did not place great reliance on the use of commodity price rules as a target for monetary policy and he also strongly did not favor a policy of targeting the exchange rate. He did believe that the steepness of the term structure of interest rates conveyed some information on the future course of inflation and unemployment.

Finally, Dr. Blinder suggested that the Congress enact legislation to create an indexed bond which would pay a return to investors that was a fixed premium above the rate of inflation.

The second witness on the panel, Dr. Budiger Dornbusch, stated in his opening remarks that the monetary and fiscal policy mix must change in the years ahead toward a reduction of the federal budget deficit and an easier monetary policy. Dr. Dornbusch presented information on the similarities between the current policy environment and the one which prevailed in this country in the late 1960's. He emphasized that while runaway inflation in the double digit range is not of immediate concern, the buildup of inflation in the upcoming period is a problem of priority.

Dr. Dornbusch then examined the rise in the foreign exchange value of the dollar that had taken place in the weeks just prior to

the July hearings. He attributed it to several causes. First, he believed that the markets expected the policy authorities had put a floor under the exchange value of the dollar that left little concern over exchange risk associated with a decline of the dollar between then and the election in November. The absence of exchange risk, coupled with higher interest rates in the United States than abroad, lead foreign investors to buy dollar-denominated investments and bid up the exchange rate.

Second, Dr. Dornbusch believed that the markets had swung from excessive pessimism to excessive optimism with regard to the pace of trade balance adjustment in the United States because of recent favorable monthly reports. Third, he believed that some investors believed that the Federal Reserve would be required to raise interest rates to keep inflation in check in the year after the election.

Looking toward the longer term, Dr. Dornbusch testified that the recent appreciation of the dollar was counter productive. He believed that in the absence of further depreciation of the real exchange rate that the U.S. current account deficit would not be reduced much below $100 billion. He also believed that there had been substantial changes in the structure of world trade which necessitate a further depreciation of the dollar.

Dr. Dornbusch suggested that the large exports of capital goods from the United States to the newly industrialized economies in the 1960's and 1970's has put in place a productive base which now produces exports to this country. He also emphasized that the devaluation of the dollar had not been sufficient to offset the productivity gains of other capital goods producers leading to a loss in competitiveness for capital goods producers in the United States.

Another cause of structural change that necessitates a further decline in the dollar, according to Dr. Dornbusch, is the cumulative growth differential that has built up over the 1980's between the United States and its trading partners. In recent years, he testified, the growth of our imports has greatly exceeded the growth of our exports for this reason.

Prospectively, Dr. Dornbusch suggested, the United States may have to let the dollar depreciate still further because the integration of trade within Europe in 1992 and the increasing intra-Asian trade between Japan and the newly industrialized economies may each displace exports from this country.

As a final recommendation in his opening statement, Dr. Dornbusch suggested that the United States adopt a financial transaction tax. He emphasized that the short term horizon of investors and the strategic interactions between the Federal Reserve and the market place in a world of high technology, combine to produce monetary policy and asset prices based on "noise and imagination" rather than on long term investment fundamentals. A financial transactions tax would, in his view, lengthen the horizon of investors and permit the fundamentals to play a larger role in the determination of asset prices. He believed that this would lead to a reduction in the consequent mis-allocation of resources.

Dr. Dornbusch did not believe that the introduction of a financial transaction tax would drive substantial business offshore as some opponents of the proposal have feared. He noted that both Switzer-

land and Japan have such a tax. He also offered that an internationally coordinated agreement of a financial transaction tax could alleviate this problem.

The third member of the panel, Dr. Ray Fair, agreed that the Federal Reserve's performance had been commendable. He also supported a change in the policy mix favoring tighter fiscal policy and easier monetary policy. In his prepared statement he reported the results of simulations that showed that a change in the policy mix would produce a bonus for federal deficit reduction because of a lowering of interest rates and the concomitant savings on servicing the national debt.

Dr. Fair then discussed the relationship between political forces and macroeconomic policy. He reported the results of research that showed that a model that utilized real GNP growth per capita and the rate of inflation in the 6 to 9 months prior to the election as explanatory variables could predict the voting shares for the two parties in presidential elections within three percent on average.

Thus, he suggested, the economy did have a major effect on electoral outcomes. At the same time he offered that because of the lag between monetary policy and the economic magnitudes that best explained the election outcome was long, it was too late by July for the Federal Reserve to exert influence on the November 1988 election. Dr. Fair also reported that, according to his model, Mr. Bush had a slight edge but the election was too close to call.

The final member of the panel, Mr. David Hale, emphasized in his opening remarks that the Federal Reserve faced a formidable challenge in modulating the economy to prevent overheating and inflation in the context of the persistence of the trade and budget deficits as a capital importing nation.

Mr. Hale suggested that the limit on capacity growth was no more than 2.6 percent and that consumption per capita would have to be roughly static over the next few years if we are to maintain growth while reducing our trade imbalance.

Mr. Hale expressed a belief that it was unfortunate that our country had to rely upon monetary policy to ration domestic demand. He believed that higher real interest rates would raise the dollar and cause our trade balance to deteriorate.

Mr. Hale presented data from the Bank for International Settlements on the proportion of dollar deposit accounts in the offshore financial system. The data showed that some substantial portfolio shifting out of dollars had occurred in recent years. Mr. Hale offered the hypothesis that some of the decline in the rate of U.S. money growth, and the increase in money growth rates abroad could be explained by the portfolio shifting between dollar accounts and foreign currency accounts.

Mr. Hale then testified that the process of international macroeconomic coordination should include publicly disclosed exchange rate targets. He applauded the provision in the trade bill which required the Treasury to report to Congress on exchange rate policy.

Mr. Hale favored disclosure of the exchange rate target for three reasons. First, he believed it would help policy makers focus on the international implications of their actions. Second, he thought that the information provided to investors would facilitate planning and reduce uncertainty which discouraged the making of irreversible

investment decisions. Third, Mr. Hale emphasized that the disclosure of exchange rate targets would alleviate suspicions that the policy authorities were manipulating the exchange rate for the purpose of influencing political elections. Mr. Hale quoted from an editorial in the Financial Times and cited a recent book on exchange rate policy and politics by Yoichi Funabashi to demonstrate that the suspicions of political manipulation of exchange markets are present in 1988.

In the question and answer period, Chairman Proxmire asked all of the panelists to evaluate the performance of the Federal Reserve. All of them suggested that the central bank was doing well currently. Dr. Dornbusch and Mr. Hale emphasized that the Fed's prospective challenge would be formidable and both suggested that a monetary policy included recession would be very taxing for the economy.

Senator Bond asked the panelists if the central bank could actually control monetary policy in the world of highly mobile international capital. Dr. Blinder believed that central banks still held the key to policymaking. Dr. Dornbusch suggested that the monetary authorities did control short term interest rates. Mr. Hale cited the similarities between the current experience in the United States and the period during Grover Cleveland's presidency when the United States was also a net debtor.

Senator Bond also asked it there was a weakening linkage between events in financial markets and in the underlying real economy. Mr. Hale referred to the stock market crash and suggested that is was very difficult, despite the crash in stock values, to have a recession in an economy with easy monetary and fiscal policies and which had just experienced a large depreciation of its currency.

Dr. Fair emphasized that the wealth effects of the crash were not that great because the stock market wealth at year's end, 1987, was nearly that same value that it was in January of 1987. Dr. Blinder offered that the bond market had rallied when the stock market fell so that the cost of investment capital had not changed much, on average.

Senator Sasser stated that he believed that our country needed lower interest rates and that we were experiencing financial fragileness in many sectors. Dr. Blinder, in his reply, stated that a recession could be very destructive and lead to a massive increase in the federal budget deficit.

Dr. Blinder also said that the current Federal Reserve Governors were comparatively recession averse and that current situation, where Wall Street was more hysterical about inflation than was the Fed, was contrary to recent experience.

Dr. Dornbusch advised that the Federal Reserve should seek to present a buoyant economy to the new Administration to increase the President's and Congress, determination to reduce the budget deficit in 1989.

Dr. Fair distinguished between a tight money policy to resist inflation and a monetary-induced recession. The former does not imply the latter in his view. Mr. Hale added to this view and described current Federal Reserve policy as fine-tuning, in contrast to a "sledgehammer" policy such as was undertaken in 1981–82.

Senator Graham asked if sufficient account was being taken of international effects on the economy. He suggested that we may be overreacting to signs of future inflation because we do not appreciate the role of international trade in limiting resource constraints.

Dr. Dornbusch replied affirming Senator Graham's view and he emphasized that the recent rise in the dollar and the deterioration in the trade balance that would accompany it was, in effect, the use of foreign resources to fight off inflation. Dr. Fair suggested that our potential for growth was bounded by technical progress and labor force growth and that if we wanted to consume more than the growth limits would allow we must import more from abroad.

Senator Graham then asked what each panelist would advise President Dukakis or President Bush to do with the economy. Dr. Fair and Dr. Dornbusch said they would advise the President to reduce the fiscal deficit. Dr. Dornbusch stressed the need to avoid a "collision between the Federal Reserve and the economy" 6 months to 1 year after the election. Mr. Hale emphasized the need for a credible multi-year fiscal package early in the next term, or even in the weeks just after the election, to assure the financial markets that the United States will undertake the needed adjustment. He also advocated negotiations of some burden sharing of defense and cited the so-called offset program between the United States and West Germany just before the break down of the Bretton Woods system as an example of this type of action in the past.

Chairman Proxmire asked the panelists if they believed that the Federal Reserve would ease monetary policy when the fiscal deficit was cut in order to avoid a recession. Dr. Dornbusch believed that they would. Dr. Blinder was not as confident and recommended a gradual fiscal reduction plan.

Chairman Proxmire then asked if it was responsible to let the dollar fall further when Europe is stagnant with high unemployment. Dr. Blinder believed that such a move would induce the Bundesbank to ease. He also believed that the rest of Europe would be stimulated because the German economy is tied to the others through the European Monetary System.

Mr. Hale believed that the high rate of unemployment in Europe was largely related to supply side rigidities. He also suggested that, in response to the previous question, he did not advocate a recession and that he desired a long period of moderate growth at full employment.

Dr. Dornbusch emphasized that the acute concern about fiscal policy did not arise because of the fear of a financial crisis but rather out of concern that the real economy would overheat unless the fiscal deficit were lessened to reduce aggregate demand.

In response to a question on the handling of the crisis in the savings and loan industry both Dr. Blinder and Mr. Hale said they believed that the taxpayer would be called upon to resolve the problem. Mr. Hale advocated the establishment of an elite, sophisticated, high paid, financial regulator to handle the problems. He was disturbed by the fact that the Comptroller of the Currency's staff had been reduced in recent years amidst widespread banking problems.

Senator Sasser asked the panel if they believed that the financial deregulation of banks was wise. Dr. Blinder believed that a wall was needed to protect depositors from the risky activities. He also suggested some use of risk-based pricing of deposit insurance. Dr. Dornbusch, Dr. Blinder, and Mr. Hale believed that technological change and international competition made it necessary to proceed with allowing banks into a broader range of activities. Dr. Fair suggested that the wrong kind of regulation was applied to the S&L industry and that we have encouraged risk taking when we should not have.

Senator Graham asked the panel about policies pertaining to the LDC debt crisis. Dr. Dornbusch said that the taxpayer would be called upon but the goal was to find a solution that minimized this aspect. He hoped that policies would be directed toward repatriating capital back into the countries and suggested that we must proceed on a case-by-case basis. Mr. Hale also emphasized reinvestment in the developing countries and hoped that some of the investment would take the form of equity rather than solely debt.

On July 13, the Committee received testimony from Dr. Alan Greenspan, Chairman of the Board of Governors of the Federal Reserve System. In his testimony, Chairman Greenspan stressed that the dangers of intensified inflation were renewed after the period of uncertainty regarding the course of the economy at the beginning of the year. Chairman Greenspan testified that the Federal Reserve had taken a succession of restraining steps between late March and early June. At the same time, while short-term interest rates had risen, longer-term interest rates remained below their peak levels of the previous year.

Chairman Greenspan revealed that the Federal Open Market Committee foresees continued growth with restrained inflation and a continuing improvement in our external balance. He suggested that capacity utilization may peak soon and that unemployment may rise slightly in the medium term.

In response to intensified wage and price increases, and in an effort to insure that the price increases associated with the agricultural drought and the rise in import prices do not become imbedded in core inflation, Dr. Greenspan testified that, "Federal Reserve policy at this juncture might be well advised to err more on the side of restrictiveness rather than of stimulus."

Chairman Greenspan then emphasized that the current statistics on inflation may under report the true rate of inflation because of the exclusion of import prices and because the weighting scheme used in constructing the index places too much emphasis on the price of computers, which have fallen since 1982.

In reference to the outlook, Chairman Greenspan predicted that the growth of M2 and M3 would be well within the target ranges for 1988 and that money growth could be somewhat lower in the following year. He emphasized that the midpoints of the target ranges for 1989 that were revealed at the hearings, are lower than the midpoints of the ranges for money growth in 1988. Chairman Greenspan then qualified his statement on the 1989 targets by suggesting that intervening events between now and the next hearings in February of 1989 could necessitate a change in the targets at that time.

Turning to the process of macroeconomic adjustment in the face of the persistent U.S. current account and fiscal imbalances, Chairman Greenspan discussed how higher real interest rates and a fall in the dollar would be required if the policy changes were not made. He cited some of the self correcting features of this adjustment process but did not see the market adjustment process in the absence of policy change as optimal. He believed that the U.S. export sector was producing at full capacity and could not benefit from further declines in the dollar at this time. He also stressed that higher interest rates associated with this unfettered adjustment process would retard capital formation.

Chairman Greenspan strongly favored policy action to reduce the federal budget deficit. He stressed that with continuing improvement in trade the U.S. economy would have less foreign funding available to finance investment. He testified that a reduction in the budget deficit would increase domestic savings and would replace the funding that is no longer available from abroad. This increase in domestic savings, he believed, would counter the rise in interest rates that would result in the absence of fiscal policy contraction.

Chairman Greenspan cited the fact that the United States has not historically always been the country with the lowest savings rate and he recommended that the United States might well be advised to aim for a budget surplus in the years ahead to counteract the low rate of private savings.

Chairman Greenspan then emphasized that the strategic role of monetary policy was implied by the ultimate objectives of high employment, a sustainable external position, and stable prices. He testified that the guidelines for monetary growth required by the Humphrey-Hawkins reports were useful as a means of calibrating monetary policy provided that they were not too rigid in the short term. Chairman Greenspan referred to an appendix of the Monetary Policy Report which analyzed some of the properties of the monetary base as an aggregate. Mr. Greenspan concluded that the monetary base did not significantly add to the information already provided by M2 and M3. He reported that the Federal Open Market Committee had therefore decided not to add a published range for the monetary base to the semi-annual Humphrey Hawkins Monetary Policy Report.

In the question and answer period Chairman Greenspan addressed questions on the influence of monetary policy on the presidential election, debt-equity ratios, external adjustment, the inflationary expectations of Wall Street, the recent behavior of the discount rate, explicit disclosure of target ranges for exchange rate policy, capacity utilization, and solutions to the savings and loan industry crisis.

Chairman Greenspan agreed that it was, for the most part, true that changes in monetary policy after mid-July no longer had much effect on the November election.

Chairman Greenspan believed that in order to assess the danger of increasing accumulations of debt one needed to look at the assets supported by the debt. He expressed some alarm that when interest rates have fallen the ratio of debt service to cash flow has remained roughly constant, implying that there had been a rise in debt.

In response to a question from Senator Garn, Chairman Greenspan expressed concern about the effects of increases in the minimum wage and about the impact of protectionist policies. This concern was raised again later in a series of questions from Senator Gramm.

In reference to a statement about Wall Street's "inflation hysteria" made by Dr. Alan Blinder at the hearing on the previous day, Chairman Greenspan suggested that it was important to monitor the "street chatter" because it often revealed something about the expectations and attitudes of the investing public. At the same time Chairman Greenspan emphasized that this was only one information input into the process of monetary policy making.

Chairman Greenspan suggested that recent estimates of the magnitude of the savings and loan crisis are necessarily imprecise because of the difficulties associated with determining a market value of the assets of the industry. In response to the question of whether the earnings on the open market portfolio of the Federal Reserve should be used to inject funds into the thrift industry, he offered that the budgetary implications would be the same as if funds were obtained through the appropriations process. At the same time he said that he was not sure if avoiding the appropriations process was either, "good precedent or good policy."

In response to a question from Senator Gramm, Chairman Greenspan said that he believes that what was done with the proceeds of debt issuance was vitally important in determining if the increase in debt was dangerous to the economy. He stated that the proceeds of debt issued to finance government deficits was rarely used to purchase investment goods that would be able to, by virtue of their productiveness, repay the interest and the principal on the debt.

Senator Graham asked Chairman Greenspan what advice he would give to the next Secretary of the Treasury regarding the developing country debt crisis. Chairman Greenspan replied that the difficulties of each particular case between debtors and creditors were different. He also believed that keeping the countries from being excluded from the international capital markets was very important. He advocated a case-by-case approach that was in essence a continuation of current policy.

Senator Heinz asked what were the key elements in the willingness of foreigners to hold dollar-denominated securities. Chairman Greenspan noted that the interest rates were one factor but that between 1983 and 1985 the dollar rose sharply while the differential in real interest rates was not increasing.

Senator Heinz then discussed an optimistic and pessimistic interpretation of the current status U.S. economy. Chairman Greenspan offered that he had been quite impressed by the productivity improvements in manufacturing that we have experienced in recent years. He then reiterated his view that allowing the dollar to fall further at the current time could ignite inflationary forces and actually reduce our international competitiveness.

On the question of the benefits of exchange rate stability, Chairman Greenspan said that he believed a stable exchange rate was a desirable goal and this goal was shared generally by the international financial community and the G–7 finance ministers and con-

tral bankers. He opposed David Hale's suggestion that the target ranges should be explicitly disclosed. He believed that disclosure of target zones would engender a tremendous amount of speculation and make the policy difficult to implement.

Mr. Greenspan suggested that while we have made some progress, we have not been as successful we could be in using the tax system to encourage a greater relative reliance on equity issuance and savings in our society. He indicated that he suspected that these policies would be very difficult to implement politically. He again recommended moving the federal budget into surplus to offset our excessive debt creation in recent years.

Senator Bond then asked whether the social security system should be off-budget. Chairman Greenspan replied that technically it should be on-budget but that regardless of Congress's decision on this question the unified budget should be moved toward surplus.

Chairman Proxmire asked Chairman Greenspan about the role of interest rates in restraining demand. Chairman Greenspan replied that mortgage interest rates did have a substantial impact on home buying but that raising interest rates on consumer credit or credit cards did not produce a clear slowdown in spending. Chairman Greenspan also expressed the view that savings in the economy as a whole appeared to be "very insensitive and very inelastic to changes in interest rates."

On the question of the reluctance of the Federal Reserve to raise the discount rate in light of the recent rise of market interest rates, Chairman Greenspan testified that in past periods the discount rate spread relative to market rates had been both higher and lower and that the current relationship is satisfactory.

Chairman Greenspan also suggested that a fiscal contraction accompanied by a fall in market interest rates would increase capital investment and that the stimulus in that sector would offset the other depressing elements and support the economy.

In regard to the effects of international trade and exchange rates on capacity utilization and inflation Chairman Greenspan has seen no evidence that the recent rise in the dollar would deter capital formation. He only partially agreed with the focus on global capacity utilization that was emphasized by Dr. Cooper of Harvard in the February hearings. Chairman Greenspan noted that we did not have excessively increasing delivery lead times except in the steel, aluminum, and a few other industries. That was, in his view, evidence that could support the notion that imports did relieve some of the bottleneck pressures. At the same time, Chairman Greenspan believed that while the presence of imports could relieve bottlenecks in a particular industry, general reliance on imports throughout the economy might cause the dollar to fall, and reignite inflation, which would harm our competitiveness.

Chairman Greenspan affirmed that he has supported a gasoline tax in the past and denied that such a tax would depress the price of energy and exacerbate both the savings and loan crisis and the regional depression in the oil producing regions.

When asked if he favored a policy of paying interest to banks on their required reserves, Chairman Greenspan expressed the view that it would constitute a major change in the way that the Federal Reserve System functions and that it would require considerable

thought. Chairman Greenspan did not believe that the budgetary consequences of this policy were clear cut because it could lead to the creation of greater profits in the banking system which could then yield some tax revenue.

Finally, Senator Bond asked Chairman Greenspan about the impact of the recent drought on the banking system. Chairman Greenspan stated that prior to the drought the banks in the agricultural regions were progressing rapidly and in some cases the drought would set back their progress somewhat, thought it would not send us back to the degree of difficulties that were experienced by these banks in the recent past.

Findings and Recommendation

Increasing international capital mobility reduces discretion in the setting monetary policy

The Committee finds that the substantial rise in the degree of international capital mobility in recent years has narrowed the scope of discretion that the monetary authorities have over the setting of monetary and interest rate policies. Small changes in perceived yields resulting from policy changes elicit rapid and very large international flows of capital.

The increase in international capital mobility is largely the result of the application to investment management of innovations in computer and telecommunications technology, and of the substantial dismantling of capital controls and other barriers to cross border capital movements by governments in the period since the breakdown of the Bretton Woods fixed exchange rate system.

In theory, the role of capital mobility in limiting the range of monetary autonomy does not depend upon whether a nation is a net debtor or net creditor. Investors from a country which is a net creditor, who have the ability to shift out of domestic assets and into foreign-currency-denominated securities in response to a policy change, can produce the same result as foreign creditors would in response to the policy action.

In fact, the sizable persistent U.S. current account deficits in this decade, and the concomitant rise of Japanese holdings of dollar denominated securities, have served to facilitate greater capital mobility and a greater sensitivity of the yen/dollar exchange rate in response to policy changes. That is because foreign investors did not have unimpeded access to the Japanese securities markets when the United States was a net creditor. At that time the Japanese financial markets were quite heavily regulated in manner that both prohibited foreign purchases of Japanese securities and Japanese purchases of foreign securities. As a result, not until Japanese holdings of dollar assets grew quite large did there exist a substantial body of investors who could subsitute between dollar-denominated and yen-denominated instruments. In addition, the Euro-yen market was not widely developed to create an offshore alternative for investors interested in holding yen-denominated securities who were prohibited from doing so by Japanese government regulations.

The integration of United States and Japanese markets is currently expanding as Japan gradully liberalizes its capital markets.

The sensitivity of the yen/dollar rate to policy changes is therefore unlikely to diminish if, at some time in the future, the United States again becomes a net creditor on its international accounts. The Committee concurs with Dr. Cooper's statement that,

> I do not believe the rapid growth of net U.S. foreign indebtedness per se will affect the ability of the Federal Reserve to set monetary policy. I do believe, however, that the increasing integration of world financial markets, the increase in gross indebtedness of the United States to foreigners, and the increased ease with which Americans can invest overseas in many forms, will result in a gradual reorientation of U.S. monetary policy to the external environment with greater attention being paid to "confidence" in the world financial community.

Foreign holdings of long-term U.S. securities makes monetary management more difficult

The Committee finds that the management of monetary policy in the current, very sensitive, international environment is further complicated by the fact that Japanese investors have accumulated large holdings of long-term U.S. Treasury securities. The Federal Reserve's instruments of monetary control are primarily directed toward short-term money market conditions. The influence of Federal Reserve policy on the stability of conditions in the long-term securities markets in less direct.

As was first discussed in the O.E.C.D. Economic Outlook in June of 1987, Japanese institutional investors chose to allocate sizable funds to long-term U.S. Government bonds from 1984 through the first quarter of 1987. In fact, in 1985 and in 1986, the net long-term capital outflow from Japan exceeded their current account surplus. The difference between the current account surplus and the large long-term capital account deficit was reportedly financed through a short-term capital inflow that was facilitated, in large part, through borrowing of dollar-denominated instruments in the Euromarkets.

By early 1987, Japanese institutional investors had a substantial presence in the U.S. long-term bond market. Their direct impact on the market was, according to the O.E.C.D. report, "compounded by their influence on expectations and the behavior of other market participants."

In 1987, with rising commodity prices and declining unemployment, investors appeared to fear that interest rates, and particularly long-term interest rates, would rise. A foreign investor holding long-term dollar-denominated securities appeared to be in danger of losing value both because of declines in the exchange value of the dollar and because of the decline in long-term bond prices associated with the expected rise in interest rates.

Periods of downward pressure on the dollar in both April and August–September were accompanied by a rise in long-term bond yields, a widening of the yield spread between United States and Japanese bonds, and a steepening of the term structure of interest rates in the United States. The Federal Reserve appeared to temporarily slow money growth in each of these episodes to attempt to

restore the confidence of investors with respect to the U.S. policy. Tightening reserve conditions and inducing short-term rates to rise, by itself, would tend to encourage investors to buy short-term instruments and substitute away from longer-term securities. At the same time investors observing the Federal Reserve's action may conclude that foreign investors have been reassured. The U.S. investors may then choose to maintain their presence in the long-term bond market despite the fact that short-term instruments have become relatively more attractive as a result of the tightening action taken by the Federal Reserve.

This delicate interaction of exchange rates, policy actions, expectations, and interest rates, is much more difficult for the Federal Reserve to manage than was the environment previously when foreign creditors predominantly held short-term instruments, whose attractiveness Federal Reserve policy could influence directly.

International capital mobility necessitates efforts to coordinate macroeconomic policies between major industrial countries

Another implication of the very high degree of international capital mobility is that U.S. financial policies are increasingly affected by actions taken by foreign authorities that are beyond the control, and at times beyond the influence, of the Federal Reserve. Monetary policy changes in foreign countries often quickly necessitate readjustment of U.S. policies.

Efforts made on the part of the Administration and the Federal Reserve to enhance the process of international macroeconomic consultation and coordination appear to promote greater sensitivity to the effects of one country's policies on others.

The process of international coordination of economic policies from the Plaza agreement in September of 1985 to the Louvre Accord in February of 1987, appeared to facilitate an orderly decline of the exchange value of the dollar from a position of extreme overvaluation. Policy authorities, through the use of announcements and joint communiques at the conclusion of their meetings, conveyed to the private market participants their sense of the appropriate trajectory for economic and financial magnitudes. These announcements served to shape and focus the expectations of financial investors in a direction that the policy makers form the leading industrial countries believed was conducive to economic adjustment. The focusing of expectations has been at times reinforced by the actual or potential use of policy instruments to promote the announced goals.

The Committee finds that in the financial markets, and particularly in the market for foreign exchange, this guidance provided by policy officials in constructive. Without the efforts of policy officials, expectations-driven trading appears, at times, to drive the prices of financial instruments and exchange rates off of their sustainable path for prolonged periods. The consequent mis-allocations in the real economy of goods, services, and factors of production, because of the reacton in these markets to the incentives created by a misaligned exchange rate, can be quite costly to the economy.

Orderly adjustment of exchange rate agreements is difficult

While the coordination of macroeconomic policies is desirable it is not without risks. The Committee finds that attempts by policy authorities to persist in efforts to stabilize exchange rates at a level that has become unsustainable can lead to abrupt and violent corrections once the markets perceive that a particular range cannot, or will not, be maintained.

This problem is compounded by the fact that the stock of assets available to the authorities for exchange market intervention are very small in proportion to the outstanding stock of private holdings of financial assets. Ultimately, if the private markets desire to move the exchange rate in a given direction, the authorities do not have significant financial power to stop them. The influence of the authorities on the market is as much related to their announcement as it is to their intervention policies. But the credibility of the announcements is fundamentally dependent upon their willingness to take policy actions to enforce their stated intentions.

A reference range for the exchange rate may be established by a series of announcements, foreign exchange intervention, and changes in macroeconomical policies which combine to shape the expectations of market participants and convince them that the range is stable and sustainable. A difficulty appears to arise when, after a period of officially supported exchange rate stability, the reference ranges must be rebased to reflect new developments in the underlying fundamentals. It appears to be very difficult for policy authorities to rebase the reference range periodically and yet maintain credibility in the view of the market.

Even after evidence mounts that a particular reference range cannot be sustained, the authorities at the central banks and the finance ministries around the world seem reluctant to face the difficulty of moving the markets to a new range that is credible out of fear that their actions could precipitate turbulence in the world's financial markets. If they avoid the difficulties of transition the result is usually one of postponing, but intensifying the violence of, the ultimate breakdown of the exchange rate agreement.

The rebasing of a reference range is difficult precisely because the authorities on whose credibility the new reference range depends are the same officials who have broken the agreement on the previous range in order to make the transition. Furthermore, with the aforementioned small stock of assets available to the authorities in relation to the stock of private assets outstanding, it often takes time, and a willingness of the authorities to use macroeconomic instruments at the expense of other policy objectives, to establish the credibility of a new reference range for the exchange rate.

In February of 1987, the United States entered into an agreement—The Louvre Accord—in an effort signal to the private markets that the dollar decline that began in 1985 should come to an end. The six countries that signed the agreement intended to stabilize the exchange value of the dollar at what was then current levels. It has been reported that this agreement was designed only to be effective until April. But in fact, other than a slight rebasing of the yen/dollar range, the reference ranges set up at that meet-

ing appeared to still be in place until October when the stock market crashed.

Throughout the period between February and October, authorities in the major countries engaged in periodic, and at times significant, foreign exchange intervention to keep the currencies within the reference ranges. Foreign exchange intervention against the dollar on the part of all countries was reported to be over $140 billion for the year as a whole according to one recent report. That magnitude suggests that nearly all of the U.S. current account deficit for 1987 was financed through official channels. In the absence of this widespread intervention the dollar would likely have depreciated much more and U.S. interest rates would have been higher.

As the time since the initial agreement proceeded, interest rate differentials widened, on average, between dollar-denominated securities and assets denominated in other currencies despite continued intervention to support the dollar. At the same time, U.S. monetary growth slowed and was at or below the lower end of the target range while monetary growth in both Japan and West Germany accelerated. At the same time, periodic monthly trade announcements in the United States revealed that the turnaround in the U.S. current account was proceeding more slowly than had been predicted. These announcements, showing little adjustment in the U.S. trade picture, raised the question of the sustainability of the U.S. current account deficit and the specter of further declines in the dollar.

The difficulties of managing the exchange rate agreement may have been compounded by the change of leadership at the Federal Reserve in August. Chairman Paul A. Volcker had attained a very substantial international reputation in the 8 years of service. His successor, Chairman Greenspan, has since attained a great deal of respect. But at the time of the change, concern about Chairman Greenspan's strong party affiliation, as well as the natural process of acquiring a reputation, may have led some investors to test the new leadership leading to the some downward pressure on the dollar and a rise in U.S. long-term interest rates. The decision of the Federal Reserve to raise the discount rate in September may have reflected these influences.

The Federal Reserve did not cause the stock market crash

The inability to control events in the U.S. financial markets in a world of policy interdependence and international capital mobility is powerfully illustrated by the events leading up to the stock market crash in October. The culmination of events that strained the Louvre Accord occurred when, in early October, West German and Japanese interest rates began to rise. To maintain the exchange value of the dollar it was necessary to preserve the differential between the yield on dollar securities on the one hand, and D-Mark and Yen denominatd securities on the other hand. U.S. interest rate had to rise if the Louvre agreement was to be defended.

In mid-October an unusually bad trade announcement was released. As Dr. Barbera stated in his testimony before the Committee,

> The October crash reflected not just the new higher rate structure, but, importantly, the announcement of an extraordinarily disappointing trade number in mid-October.

These difficulties were compounded by the press reports of tension between Treasury Secretary Baker and the West German authorities. In an article published on the front page of the New York Times on Sunday, October 18th, the text began,

> In an abrupt shift from its policy of the last eight months, the United States is allowing the dollar to decline against the West German mark, a senior administration official said today.

The article goes on to suggest that the dollar could decline against several other currencies as well. This article, according to many market participants, was widely interpreted to be an official announcement that the Louvre Accord reference ranges for the exchange value of the dollar had been discontinued.

On the next day, October 19th, in early trading the yield on 30 year Treasury bonds rose markedly. Investors appeared to sell long term bonds with the expectation that foreign investors were going to sell in order to avoid a loss resulting from the depreciation of the dollar following the remarks of the Treasury Secretary.

At the same time, the U.S. equity market had remained at the point where the relationship between interest rates and the price/earnings rations was unsustainable. A correction in stock values appeared to be inevitable.

The fact that bond yields rose abruptly, because of the overdue breakdown of an exchange rate agreement, may have triggered the correction. But the speed and the extent of the correction cannot be explained by the triggering event alone. The magnitude of the decline, 508 point drop of the Dow Jones Industrial Average, was intimately related to the failure of market mechanisms in the stock market systems themselves.

The Committee finds that the joint Federal Reserve-Administration policy of exchange rate targeting may have postponed necessary adjustments in the exchange rate and have led to a sizeable and abrupt ultimate correction of market prices to reflect underlying fundamentals. The policy may also have led to undesirable restrictive monetary policy which was used to defend the agreement. But the cause of the stock market crash cannot be put solely on the shoulders of the Federal Reserve. The exchange rate agreement was the product of joint Administration-Federal Reserve policy. If the Federal Reserve can be faulted, it is for not pursuing a policy that was more independent of the Administration and which put less emphasis on the goal of exchange rate targeting. But the Committee recognizes the difficulties for the Federal Reserve on this issue in view of the fact that the Treasury is formally in charge of the exchange rate management.

Two of the witnesses on the panel expressed concern about these institutional arrangements which place the responsibility for exchange rate management in the Executive branch. Dr. Soss stated,

> The foreign exchange value of the dollar is one policy matter on which the Fed's independence is deliberately

circumscribed. The dollar is an instrument of foreign relations and foreign trade polices, and as such falls within the purview of the Executive. The Treasury Secretary has a particularly influential role in determining how much weight the Federal Reserve may give the dollar in monetary policy. This has been evident throughout the G–5 (G–78) process since mid-1985.

Dr. Cooper Stated,

> * * * there is a serious anomaly in the present U.S. arrangements and that is that the Federal Reserve is formally in charge of domestic monetary policy but the Treasury is formally in charge of exchange rate policy. That was an arrangement that worked perfectly well under the Bretton Woods system in which the U.S. was the passive player and we didn't intervene actively in exchange markets. That is an anomalous arrangement in a world of flexible exchange rates and it is one of the source of the tensions that exist between the Treasury and the Fed today.

The Federal Reserve's performance during the stock exchange crisis is to be commended

The Committee finds that the Federal Reserve's response to the stock market crash was appropriate, skillful and commendable. Many market participants have remarked to the Committee in hearings on the stock market crash that the actions taken by the Federal Reserve were instrumental in limiting the extent of the damage in the financial sector and confining the problems so that they did not spread throughout the financial system and to the economy at large. The witnesses on the panel agreed that the Federal Reserve's performance was very able in a difficult circumstance.

Political pressure on the Federal Reserve by the administration has been excessive

The Committee finds that since the time of the stock market crash in October of 1987, the Federal Reserve has come under excessive political pressure from the Administration. In particular, The Chairman of the Council of Economic Advisors, Beryl Sprinkel has made repeated attempts to influence Federal Reserve policy through the press and through criticisms published in the Economic Report of the President for 1988. Also, Assistant Secretary of the Treasury Michael Darby wrote a letter to the Governors of the Federal Reserve Board and to the Reserve Bank presidents on the Federal Open Market Committee just before, the February meeting suggesting that money growth was too slow.

The Committee finds that the Administration's actions are ironically counter productive given their own expressed desires. As Chairman Greenspan suggested at the hearing, attempts to make the Federal Reserve act in a particular direction could result in the Fed acting less vigorously than it otherwise would in the recommended directions, or acting in a particular direction could result in the Fed acting less vigorously than it otherwise would in the recommeded direction, or acting in a direction contrary to the sugges-

tions of the Administration, in an effort to preserve the Federal Reserve's reputation for independence. The problems of political independence are particularly acute at the present time when all members of the Board of Governors were appointed by the Reagan Administration.

The Committee also finds that the attempt by some within the Administration to suggest that tight monetary policy in 1987 was either responsible for the stock market crash or for type negative consequences that could follow are somewhat diversionary. The Administration, along with the Federal Reserve, was responsible for the exchange rate agreement that necessitated the slow money growth to stabilize the exchange value of the dollar. The Administration is therefore jointly responsible for the slow rate of money growth and any of the resulting consequences. Attempts to single out the Federal Reserve as the scapegoat for the stock market crash or any of the consequences of the slower than normal growth in the money supply are therefore incredible.

The Committee recommends that for the benefit of the economic prosperity of this nation, the Administration should refrain from counterproductive efforts to blame the Federal Reserve for the outcome of policy which it has been an integral party to the creation of. The Committee also recommends that the Administration refrain from excessive efforts to influence the course of monetary policy in a Presidential election year.

Fiscal deficit reduction would help to stabilize international financial markets

The current extreme sensitivity of the foreign exchange markets and capital markets to policy change in the United States could diminish for fundamental reasons if the United States trade and budget deficits were to diminish to proportions that were within a sustainable range. At present, the volatility of the dollar and the pressure on the monetary authorities to react to periods of dollar weakness appear to be compounded by the concerns about the sustainability of the persistent sizable current account deficit. Monthly trade announcements, based on very preliminary and incomplete estimates of the export and import picture, are likely to continue to produce substantial movements in the exchange value of the dollar and swings in interest rates.

In the early 1980's, the emergence of the federal budget deficit was accompanied by a rise in the dollar, a large net capital inflow, and a current account deficit. The budget deficit was said by some to be "crowding out" U.S. exports and import-competing industries. In the absence of substantial federal budget deficit reduction in the near future, as the U.S. export and import-competing industries continue to improve in lagged response to the decline of dollar since early 1985, the crowding out of the sectors engaged in international competition is likely to be replaced by the crowding out of interest-sensitive industries.

If the current conditions were to persist indefinitely, foreign creditors might demand an increasing yield premium that would drive up U.S. interest rates for several reasons. First, they might come to fear that the United States net external indebtedness will grow to such a proportion that its willingness to meet its obliga-

tions becomes uncertain. Secondly, they may fear that in the absence of substantial improvement in the trade deficit there will be mounting pressure for a further decline in the exchange value of the dollar. Finally, foreign investors may merely demand a premium for bearing the risk of foregoing diversification and holding ever larger proportions of dollar-denominated investments in their portfolios.

As interest rates, and particularly inflation-adjusted interest rates, [real interest rates] rise in this country, from their already historically high levels, the Federal Reserve's policies are likely to come under increased scrutiny. The Federal Reserve's actions, in conjunction with those of other central banks in the industrialized countries, will directly affect the orderliness of this process as they manage the unfortunate tradeoff between real interest rate increases and a rise in future inflation that would accompany efforts to resist the rise of interest rates.

Persistent high real interest rates are a significant deterrent to the modernization of our capital stock and the concomitant gains in future productivity. Inflation creates economic uncertainty and would have to be subsequently reduced by another painful experience with disinflation. It is therefore the recommendation of the Committee that prompt and substantial action to reduce the federal budget deficit is necessary to produce more balanced non-inflationary growth in the future.

The monetary target ranges are presently inadequate to convey information to the public about the intentions of the monetary authorities and the reasons for past policy performance

In the past year the Federal Reserve has chosen to drop the M1 target from the target ranges that it reports to the Committee. The Federal Reserve has also broadened the range of the targets for M2 and M3 from 3 percent to 4 percent. It is of great concern to the Committee that the quality of information provided for Congressional oversight has been greatly diminished.

Chairman Greenspan provided an excellent and detailed explanation of the basis for the Federal Reserve's decision to make the changes that it has. The Committee affirms that, as was expressed by Chairman Greenspan, the attainment of the monetary targets is not an end in itself, but a means to achieving the goal of long-term economic growth consistent with price stability.

The Committee believes that the social value of the targets for the monetary aggregates largely depends upon their role in facilitating the transfer of information to participants in the marketplace who are engaged in economic planning. The target announcements convey information to the public about Federal Reserve policy intentions both at the time of the announcement and in subsequent hearings, when the Federal Reserve's explanation of its reasons for deviating from the stated targets are revealed.

The target ranges published by the Federal Reserve in the February and July reports are inadequate to serve the role of information provider. Were the target ranges a binding constraint on the making of monetary policy this widened range would be advisable for precisely the reasons that Chairman Greenspan suggested in his February testimony. But the Federal Reserve is not required to

constrain policy to stay within the target range. The Federal Reserve Act states,

> Nothing in this Act shall be interpreted to require that the objectives and plans with respect to the ranges of growth or diminution of the monetary and credit aggregates disclosed in the reports submitted under this section be achieved if the Board of Governors and the Federal Open Market Committee determine that they cannot or should not be achieved because of changing conditions: *Provided,* That in the subsequent consultations with, and reports to, the aforesaid Committees of Congress pursuant to this section, the Board of Governors shall include an explanation of the reasons for any revisions to or deviations from such objectives and plans. (12 USC 225a)

Therefore, it is the recommendation of this Committee that the Federal Reserve provide in its report to Congress, ranges for the aggregate targets that are not unduly wide in light of the need to provide useful information to the public about the intentions of the Federal Reserve in setting monetary policy in the future. Furthermore, to facilitate meaningful oversight of monetary policy, and to promote a clearer public understanding of the making of monetary policy, the Committee requests that henceforth, the Federal Reserve provide an explanation in its written testimony which does explain any deviation of the monetary aggregates from the midpoint of the range that was established at the previous hearing to pertain to the period in question.

In addition, in light of the evidence presented in the reply to the questions for the record, which showed that the monetary base velocity was considerably less volatile than M1 velocity in this decade, the Committee requests that the Board of Governors undertake a detailed study of the advisability of replacing the target range for the M1 with a target range for the monetary base in its report to Congressional committees. The Committee asks the results of this study and the Federal Reserve's recommendations be reported to the Committee, in writing, no later then December 31, 1988.

The risks of inflation currently outweigh the risks of recession

At the time of the hearing in late February, Chairman Greenspan testified that the balance of risks between inflation and recession were nearly equal after the Federal Reserve had taken a small easing step. At the time of the Federal Reserve's easing step the indicators of economic activity show a mixed outlook with some signals suggesting that a recession was imminent.

Many of the indicators which suggested that the economy was weakening in the aftermath of the stock market crash have since turned around and led support to the view that the economy is strengthening. A stronger than expected performance in the export and import-competing sectors, declines in unemployment, a rise in consumer confidence, and signs of a pick-up in investment combine to suggest that the current risk of inflation is greater than that of recession.

In the months since the hearings in February, the Federal Reserve Board of Governors and the Federal Open Market Committee acted in response to signals of a reinvigorated economy and they have taken a serious of small tightening steps. At first, in late March they reversed the easing step of January. Then in May and June, according to Chairman Greenspan's July testimony, they took further steps to tighten as the outlook for economic activity continued to strengthened.

The Committee believes that the long run health of the economy depends upon the confidence of our citizens that inflation will not be allowed to return. The Committee finds that the current risk of renewed inflation is greater than the risks of recession. In such an environment, and in the absence of fiscal deficit reduction, the responsibility falls upon the Federal Reserve to resist political pressures for easy money. The Committee finds the monetary policy of the Federal Reserve in recent months to be appropriate.

The need for monetary accommodation to maintain economic growth in at the time of Federal budget deficit reduction should take precedence over exchange rate stability

The Committee recommends that in the current setting that a reduction of the federal budget deficit would provide for better balanced economic growth in the longer term despite the short term difficulties of the transition. In the short-term, fiscal deficit reduction would alleviate fears of an overheating economy and renewed inflation caused by the increase in activity spurred by the export sector. The growth in export and import-competing industries would, to some extent, offset the decline in activity caused by fiscal tightening, provided that the dollar is permitted to decline somewhat further when the federal budget deficit is reduced. At the same time, the Committee finds that fiscal deficit reduction can be implemented with less painful and costly adjustment if it is accompanied by monetary accommodation to keep the economy growing vigorously.

When discussing benefits of interest rate reductions in directly reducing the budget deficit at the July hearings, Dr. Fair stated,

> So any discussion that takes place on how contractionary fiscal policy should be in the future should take this effect into account, assuming the Fed responds to offset the contractionary effects, and I see no reason it wouldn't, aside from perhaps worries about the dollar * * *.

Undoubtedly, the periodic bouts of inflation hysteria on Wall Street that Dr. Blinder discussed in the July hearings, and the community of foreign investors concerned with dollar depreciation, will combine to create pressure on the Federal Reserve to restrain the decline interest rates and the foreign exchange value of the dollar when fiscal deficit reduction is implemented. The Committee recommends that the Federal Reserve resist those pressures and provide monetary accommodation to complement the contraction in fiscal policy in the years ahead.

Further dollar decline may become necessary to maintain economic growth because the stimulus from traded goods will subside as the delayed effect of the depreciation of the dollar from 1985 to

early 1987 propagates more completely through the system. By lowering interest rates and permitting a further decline in the dollar when the deficit reduction is implemented, the Federal Reserve can promote vigorous economic growth which will help Congress and the President to maintain their resolve to meet a multi-year budget deficit reduction plan. The pressures for new spending programs which would compromise efforts to credibly reduce the budget deficit could mount if economic growth is permitted to languish as a result of efforts to stabilize the dollar.

ADDITIONAL VIEWS OF SENATOR JIM SASSER

I do not share the view of the Chairman that the risks of inflation currently outweigh the risks of recession. It is not clear that the recent high rates of capacity utilization in some sectors of the economy constitute an inflationary danger. After several years of persistent overvaluation of the exchange rate [primarily the result of abnormally high interest rates in the early 1980's] and rising competition from abroad, those sectors are bound to operate at higher capacity levels as they increase [particularly export] production.

Nor does the current relatively low unemployment rate necessarily signal a wage/price spiral. Indeed, the demographic characteristics of today's unemployed work force stands in sharp contrast to 14 years ago when unemployment was at the same level and the economy began to overheat. Today there are twice as many mature and easily employable workers among the unemployed as there were in 1974, when teenagers comprised a very large segment of the unemployed.

There is considerable concern that the Federal Reserve will overreact to perceived overcapacity in the economy by raising interest rates and risking recession. High interest rates serve to increase the cost of capital, retard capital formation and create upward pressure on the exchange value of the dollar. Higher interest rates could very easily stifle the current boom in the export sector that the economy is experiencing.

Moreover, high interest rates run the risks of a recession that our economy and this nation can ill afford. Deficit reduction would become all but impossible in a high interest rate environment. Indeed, Ray Fair testified before the Committee that just a one percentage point increase in rates on three month Treasury bills could increase the fiscal deficit by $5.6 billion per year.

High interest rates will also exacerbate the crisis in the savings and loan industry and make it more difficult for developing countries to meet the requirements to service their external debt—a threat to the safety and soundness of the banking industry. For all these reasons, I agree with Chairman Greenspan and the panelists that fiscal reduction would be preferable to further tightening of monetary policy as a means to prevent an upswing in inflation. The Federal Reserve must permit the Congress and the Administration to continue their progress on the budget deficit by holding interest rates at a level that will sustain economic growth. An over reaction to inflation at this point has the potential to send the economy into a very deep and dangerous recession.

JIM SASSER.

ADDITIONAL VIEWS OF SENATORS GARN, GRAMM, BOND, AND KARNES

The foregoing Monetary Policy Report criticizes the Administration's conduct of foreign-exchange-rate policy during 1987, but the criticism is based on a misunderstanding of that policy. The Report erroneously asserts that the United States committed itself to a "Joint Federal Reserve—administration policy of exchange rate targeting" in the Louvre Accord of February, 1987. The Administration made no such commitment and, even if it had wanted to, could not have made such a commitment on behalf of the independent Federal Reserve.

In point of fact, the United States in the Louvre Accord agreed to eschew talking the dollar down and also agreed to not object to other countries' adopting policies which would limit further appreciation of their currencies. The Accord did not constrain Federal Reserve monetary policy in any way. Thus it is simply wrong to blame the tightness of the Federal Reserve's monetary policy in 1987 on commitments made by the Administration in the Louvre Accord.

The foregoing Monetary Policy Report, moreover, is inconsistent in its treatment of the relationship between the Administration and monetary policy in 1987. As already noted, the Report claims that the Administration forced the Federal Reserve to tighten monetary policy. The Report then proceeds to criticize Treasury Secretary Baker for refusing to pressure the Fed to tighten monetary policy to conform to that of the German central bank at existing rates.

To do so would have put the United States on a de facto mark standard in violation of both the Federal Reserve Act and common sense. The foregoing report cannot have it both ways and criticize the Administration for allegedly forcing the tightening of monetary policy to defend the exchange rate and then criticize the Treasury Secretary for steadfastly refusing to exert such pressure.

All the available evidence suggests that if concern about dollar depreciation was a factor in the tightening of monetary policy during the spring and summer 1987, it was due to Federal Reserve officials' concerns about possible inflationary effects and not due to any Administration pressure or agreement.

The foregoing Report loses objectivity and perspective when it tries to portray two Administration officials' comments on monetary policy in early 1988 as an effort to exert improper political pressure on the Federal Open Market Committee (FOMC). The two officials criticized by the Report are Council of Economic Advisers Chairman Beryl W. Sprinkel and Treasury Assistant Secretary for Economic Policy Michael R. Darby.

In particular, the Report castigates Chairman Sprinkel for critical comments on the conduct of monetary policy contained in the

Economic Report of the President. This is a document whose annual publication is mandated by the Employment Act of 1946 and the Full Employment and Balanced Growth Act of 1978.

The section of the U.S. Code mandating the Council of Economic Advisers to produce an annual Economic Report specifically requires that Report to include:

> * * * a review and analysis of recent domestic and international developments affecting economic trends in the Nation * * *.

The law also requires the Report to evaluate "policies and programs" for achieving such economic objectives as low unemployment, high growth and low inflation.

It is hard to imagine how the Chairman of the Council of Economic Advisers could produce an Economic Report meeting these legal requirements without discussing both of the major tools of macroeconomic policy: fiscal policy and monetary policy. The bottom line is that Congress should not criticize the Council's Chairman for complying with legislation passed by the Congress.

The Report also criticizes Chairman Sprinkel for speaking "through the press" on monetary policy. If the Senate Banking Committee really feels that the Chairman of the Council of Economic Advisers' opinions on monetary policy should not be made public, it is hard to understand why the Committee has repeatedly invited the Council Chairman to testify publicly at the Committee's semi-annual monetary policy hearings.

The Senate Banking Committee report attacks Treasury Assistant Secretary Michael R. Darby for sending a letter on January 21, 1988, together with some of the Treasury's own research findings to the members of the FOMC. The House Banking, Finance and Urban Affairs Committee in April 1988 produced its own report evaluating allegations that this was improper.

The House Banking Committee concluded that:

> Such criticism is entirely misplaced. The Assistant Secretary's letter * * * summarizes and conveys potentially important information about the relationship between money and the economy. The only legitimate question concerns the validity of the Treasury research findings—a question which the Board of Governors, backed by its own substantial research capacity, is well equipped to address. Potential infringement of FOMC independence or undue outside influence on the conduct of monetary policy * * * should be of no concern at all if the Administration—or the Congress, or the general public—offers the Federal Reserve policy advice and research findings concerning the impact of monetary policy on the economy.

The Chairman and other members of the Federal Reserve's Board of Governors frequently critique the conduct of fiscal policy by the Congress and the Administration. Recent statements by Federal Reserve Board Chairman Alan Greenspan and former Chairman Paul Volcker calling for lower fiscal deficits clearly have contributed to the debates over economic policy.

Service as Chairman of the Board of Governors or in any other capacity with the Federal Reserve System should not preclude an individual from participating in the public debate over fiscal policy. Similarly service in the Executive Branch or in the Congress should not preclude an individual from participating in the public debate over monetary policy.

JAKE GARN.
PHIL GRAMM.
CHRISTOPHER S. BOND.
DAVID K. KARNES.

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